



United States
Department of
Agriculture



Agriculture
Information
Bulletin No. 724-01

March 1996

Can Federal Action Improve Efficiency in the Market for Farm Loans?

Federal actions could improve efficiency and competition in the market for farm loans by lowering barriers to market entry and reducing market segmentation. Such actions might include changes to existing charters of Government-sponsored enterprises (GSE's), regulatory reforms affecting commercial banks and GSE's, and continued antitrust vigilance. Federal action may be justified because 93 percent of rural banking markets are still classified as noncompetitive despite past Federal action. Previous action improved efficiency by integrating isolated rural credit markets with national money markets and by promoting market innovation.

Financial market efficiency is essential to sustaining reasonable rates of economic growth. Improved market efficiency adds to the resources available to society, so moves toward efficiency are potentially self-financing. Largely private, competitive financial systems have proven effective in attaining efficiency.

In a perfectly competitive financial system, lenders would be forced to either attain efficiency or exit the market. Federal policies that increase lender competition, lower transaction costs, or improve information availability have enhanced efficiency. However, the Department of Justice classifies 2,111 of 2,283 rural banking markets as noncompetitive (fig. 1).

Financial markets affect economic growth rates by the way lenders allocate capital to businesses. Lenders

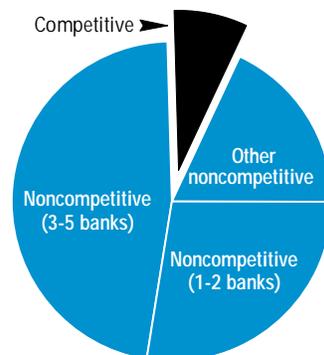
must choose among borrowers with productive uses for capital and, in the process, allocate capital among competing uses. If lenders make loans to enterprises that generate insufficient profits to allow for repayment with interest, capital has been poorly allocated and economic growth suffers.

Private lenders who make bad loans will be forced to exit the market. Public lenders, however, rarely succeed in allocating capital efficiently and are often not intended to do so. Public lenders often aim to preserve existing businesses or to equalize economic opportunities to reduce income inequality. A challenge to policymakers is to identify actions that address legitimate policy goals without harming financial market efficiency.

Past Policies Increased Efficiency, But Markets Were Segmented

Some market efficiency programs, including GSE's serving agriculture (the Farm Credit System (FCS) and the Federal Agricultural Mortgage Corporation (Farmer Mac)), were developed to overcome barriers to competition or to financial flows caused by restrictive banking laws and regulations or geographic isolation and limited communications technology (see box). In many cases, U.S. financial markets have been purposefully segmented. Until recently, many States restricted within-State and interstate branching by financial institutions. The Glass-Steagall Act of 1933 segments commercial banking markets from investment banking and insurance markets. Many other laws and regulations reduce the ability of finan-

Figure 1
Competition in rural banking markets
Business activity in noncompetitive markets is concentrated among few banks.



Data as of June 30, 1993.
Sources: Compiled by USDA's Economic Research Service from Federal Reserve Board data and Dept. of Justice classifications. The definition of competitiveness is based on the number and sizes of banks in a market.

What Is a Government-Sponsored Enterprise?

Since 1916, Congress has created Government-sponsored enterprises (GSE's) to improve credit availability and enhance financial market competition to specific sectors of the economy including agriculture and rural areas, housing, and education. Each GSE is privately owned and operated, is limited to a specified economic sector, and receives direct and indirect Government benefits to help it accomplish its mission. Two GSE's serve agriculture and rural areas: the Farm Credit System (FCS) and Federal Agricultural Mortgage Corporation (Farmer Mac). The FCS is a network of cooperative lending institutions established in 1916. It operates as a direct lender to agricultural producers, agricultural cooperatives, farm-related businesses, and rural residents. Farmer Mac, established in 1988, was designed to operate as a secondary market in agricultural real estate and rural home loans.

cial institutions to compete freely and to channel funds efficiently.

The FCS helps to equalize the cost and availability of credit in local markets by offering credit to farmers on fairly uniform terms nationwide. In theory, its mandate to serve agricultural producers nationwide also enhances competition in local markets. If Farmer Mac becomes viable, it would also enhance market efficiency.

The U.S. Small Business Administration (SBA) offers another example of Federal intervention in credit markets that has been justified on economic efficiency grounds. This program was predicated on the failure of commercial banks to offer medium-term loans during the Great Depression. Continuation of the SBA is partly based on the premise that risk-averse banks will deny loans that could improve economic growth and thus benefit society.

The SBA, GSE's, and direct Government lending programs all provide the farm sector with some insulation from cyclical debt rationing by commercial lenders. The Federal Reserve Board has indicated that such insulation provides it additional flexibility in conducting monetary policy.

Direct and Indirect Effects of Federal Policies

Government actions can improve market efficiency, but Government actions also have perpetuated market inefficiency through restrictive legislation and regulation. Many Federal policies and programs directly and indirectly affect credit market efficiency.

Credit market programs aimed at *directly* improving efficiency often work through private or quasi-private lenders to enhance the operation of financial markets. If services are competitively priced, delivered efficiently, and market failures indeed exist, such programs need not be targeted, require no Government oversight beyond the usual necessary to assure safe and sound operations, and can be operated at no net cost to the taxpayer over the long run. For example, the Federal Housing Administration provides guarantees on privately made mortgages to first-time homebuyers and others. The guarantees encourage lenders to make more mortgage credit available in areas and to borrowers who may not otherwise qualify for conventional loans. This program is self-financing through mortgage insurance premiums paid by borrowers.

Federal programs that *indirectly* affect credit market efficiency include policies, laws, and regulations in the areas of antitrust, banking activities, bank chartering, bank safety and soundness, bankruptcy, and financial contracts. Although such laws and regulations are necessary for efficient credit markets to develop, when overly restrictive they can both stifle competition and facilitate market segmentation.

Other factors that allow noncompetitive conditions to persist (isolation and lack of technology) may be changing. Improved telecommunications have the potential to allow private market activity to increase competition in many farming areas. Similarly, continuing market innovations—such as greater use of customized financial contracts—and demographic changes—increased education and fewer, larger farms—lower the costs of information and credit delivery and reduce the ability of local lenders to segment markets geographically, by loan size, or by loan collateral. Such changes could also allow some rural-based lenders to attain economies of scale previously available only in larger localities.

These changes could eventually reduce the need for direct Government intervention to enhance rural credit market efficiency. Thus, an important factor to consider when weighing policy alternatives is the potential to terminate Government programs or terminate the special status of GSE's as their public policy importance ebbs.

Modifying Existing Policies Can Enhance Efficiency

Three basic policy modifications for enhancing credit market performance include:

- retail loan making through GSE's,
- operating secondary markets, and
- lowering barriers to entry caused by legislation, regulation, or monopolistic competitors.

Retail Loan Making Through GSE's.

The FCS is the only GSE chartered to make loans directly to borrowers at the retail level. Other GSE's provide liquidity to retail lenders by operating secondary markets for eligible loans or by taking such loans as collateral for advances. The FCS was organized as a network of retail lending cooperatives because rural banks were unable to offer long-term loans and because rural bank market power was a longstanding policy concern.

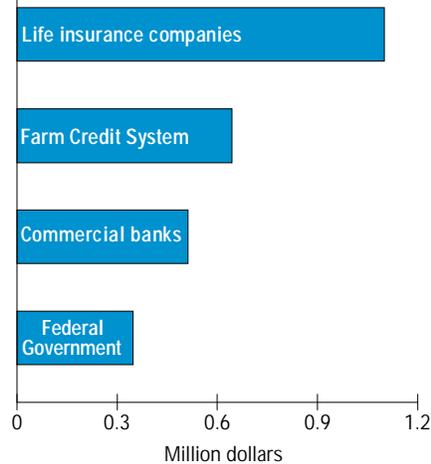
The persistent lack of competition in local agricultural and rural lending markets provides adequate justification for Federal interest in fostering such competition. However, the structure of direct Federal and State programs, GSE charters, and banking laws has encouraged the segmentation of agricultural loan markets. For example, struggling and low-resource farms are served mostly through Federal and State direct and guaranteed loan programs; lending to part-time farmers is dominated by commercial banks; and bigger, full-scale, commercial-size farm lending is dominated by FCS lenders and insurance companies (fig. 2). Stratification and segmentation also occur in housing markets.

Various barriers and competitive advantages, including subsidies, capitalization rules, local physical presence, and organizational structures, make this segmentation sustainable. But such segmentation also illustrates that lender competition remains imperfect despite the presence of the retail-level GSE. Thus, the Congressional intent in chartering the FCS remains unfulfilled: to provide an alternative lender that would be “responsive to the credit needs of all types of agricultural producers having a basis for credit.”

The Farm Credit Administration, which regulates agricultural GSE's, is reviewing its regulations to determine the extent to which they unnecessarily limit FCS competitiveness in some market segments. Unlike housing GSE's, the FCS has no binding obligation to target any particularly vulnerable or underserved segments of the farm loan market. Also, the exclusive territories contained in FCS charters would be considered an unlawful restraint of trade under antitrust laws if they were not mandated by Federal law. These exclusive territories perpetuate FCS lenders' high operating profits and high FCS inefficiencies.

Policy changes that would enhance retail-level competition among the FCS and other commercial lenders include removing exclusive territories,

Figure 2
Average net worth of commercial farmers, by lender, 1991-93



Source: USDA, Economic Research Service, Farm Costs and Returns Surveys.

changing FCS authority to lend to other financial institutions, and imposing requirements to ensure FCS institutions do not ignore significant farm lending submarkets.

Operating Secondary Markets.

Most GSE's provide liquidity to retail lenders by operating secondary markets for eligible loans or by taking such loans as collateral for advances. Secondary markets supply liquidity to local markets beyond that available from local deposits. In addition, secondary markets integrate local credit markets to national money markets by facilitating the flow of funds and reduce variability in the cost of funds among markets. By standardizing contractual arrangements for certain eligible loans and by providing data necessary to judge loan performance, GSE's have also helped attract additional capital to sectors they are chartered to serve. Economists estimate that housing GSE's lower the annual effective interest rate on eligible loans by about 0.5 percentage point. This rate decrease is due to both subsidies and improvements in market efficiency.

Some secondary market GSE's have also enhanced retail-level competition for making eligible loans by encouraging new entrants. This is particularly true for housing GSE's, which spawned the

very competitive mortgage banking industry. In contrast, the Federal Home Loan Bank System (and Sallie Mae) can only provide advances to member thrifts and banks. Thus, these GSE's provide benefits to specific competitors but do not encourage enhanced competition through new entry into the retail market for eligible loans.

GSE's are also unnecessarily shielded from competition. A major distinguishing factor among GSE's is the sector of the economy each is chartered to serve; otherwise most GSE's perform essentially the same function. This segmentation prevents GSE's from diversifying across industries, thereby increasing their exposure to sector-specific risk. This increased risk exposure also increases the contingent liability attached to the implicit Federal backing associated with a GSE charter. Sector-specific chartering of GSE's shields many of them from direct competition with other GSE's. Limiting competition among GSE's provides them with market power and reduces their efficiency-enhancing effect on financial markets.

Policy alternatives related to secondary market GSE's include broadening existing GSE charters to allow GSE competition to serve farm loan markets, expanding existing charters to allow both the buying and pooling of whole loans and also rediscounting of eligible loans pledged as collateral. Separate secondary market institutions to serve each sector are not necessary and may be counterproductive because such institutions bear more risk than necessary and because they may not be viable for relatively small sectors of the economy such as real estate lending to production agriculture.

Lowering Barriers to Entry.

A third policy alternative for enhancing credit market performance involves removing artificial barriers to competition combined with enforcing of antitrust laws. One of the Government's roles is to create a business environment conducive to private competition which will, in

turn, deliver benefits to market participants. Such policies have been undertaken in many heavily regulated sectors in recent decades including transportation (rail, truck, and airline), telecommunications, natural gas production and transmission, and (to a more limited extent) electricity generation. Recent developments in financial regulation, including a new law governing interstate banking and other initiatives, indicate reform is occurring in credit markets, too.

Such policies encourage innovation, organizational flexibility, and efficiency, and allow for more rapid adjustment to new technology, changing demographics, and other changes that occur in heavily regulated markets. However, some deregulated markets have evolved in noncompetitive ways that partially thwart the intent of deregulation. A familiar example is the ability of some airlines to control large shares of traffic at particular airports. Thus, deregulation may not automatically lead to sustained competitive business environments without ongoing antitrust vigilance.

Many rural financial markets are too small or diffuse to support a competitive array of locally based lenders. The potential exists in some rural areas and market niches for nontraditional or nonlocal competitors using telecommunications or computer networks to create competitive pressures once they gain acceptance from local consumers, but this promise is remote for some niches.

Competition could be further enhanced by harmonizing the charters of various lenders to reduce market segmentation. Currently, the GSE status of FCS associations affords them advantages

in providing larger, longer-term loans, while banks' ability to provide a full array of financial services, as well as accept insured deposits, gives them a competitive advantage among small to mid-sized, largely part-time, farms.

In addition, severe penalties levied on associations that seek to be rechartered outside the FCS and exclusive charters that prevent multiple FCS lenders from serving a given locality prevent the FCS from enhancing local market competition as much as possible.

Policy alternatives include harmonizing charters and other regulations to reduce segmentation, encouraging entry in concentrated markets through nontraditional mechanisms including electronic funds transfers and telecommunications, and continuing antitrust vigilance.

Conclusions

The major factors contributing to financial sector inefficiency in farming areas include geographic isolation, low population densities, and State and Federal policies that limit market entry and competition. Government actions have improved market efficiency, but they also have perpetuated market inefficiency through restrictive legislation and regulation. In contrast to earlier policies that resulted in many segmented and noncompetitive rural financial markets, further Federal actions now, including changes to existing GSE charters and regulatory reform for all lenders, could enhance efficiency and competition by lowering barriers to market entry and reducing market segmentation.

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Further Readings

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